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PAGE 02 ROME 02694 060232Z

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SUBJECT: CENTRAL BANK GOVERNOR RAISES WARNING SIGNS

1. (U) SUMMARY: CENTRAL BANK GOVERNOR ANTONIO FAZIO HAS HARSHLY CRITICIZED THE GOVERNMENT FOR FAILURE TO REIN IN THE PUBLIC DEFICIT, WHICH HAS BALLOONED TO NEAR E41 BILLION. THE CRITICISM, THE FIRST OPENLY SOUR NOTE BETWEEN THE CENTRAL BANK AND THE GOVERNMENT, WAS MADE AT THE BANK OF ITALY'S ANNUAL MEETING ON MAY 31. REACTING QUICKLY TO THE CRITICISM, FINANCE MINISTRY TREMONTI DEFENDED THE GOVERNMENT'S ECONOMIC PROGRAM. DESPITE CONCEDED THAT THE DEFICIT WAS UP AND GROWTH STAGNATING, TREMONTI SAID THERE WOULD BE NO MID-YEAR CORRECTIVE BUDGET. END SUMMARY.

2. (U) ON MAY 31, THE BOI GOVERNOR ANTONIO FAZIO, AT THE PRESENTATION OF THE BANK'S ANNUAL REPORT, RAISED CONCERNS ABOUT THE PUBLIC DEFICIT, WHICH HAS INCREASED BY E4 BILLION OVER THE SAME TIME PERIOD OF 2001. HE ARGUED FOR A SUPPLEMENTAL BUDGET PACKAGE TO BRING PUBLIC FINANCES MORE IN LINE WITH THE STABILITY PACT TARGETS. WARNING THE GOVERNMENT ABOUT THE FAILING HEALTH OF THE PENSION SYSTEM, HE UNDERScoreD THE URGENT NEED FOR REFORM. HE ALSO CALLED FOR IMPLEMENTATION OF AN AMBITIOUS INFRASTRUCTURE PLAN, A CORNERSTONE OF THEN-CANDIDATE SILVIO BERLUSCONI'S CAMPAIGN IDEAS TO JUMPSTART THE ECONOMY, AND THE ACCELERATION OF PRIVATIZATION. FAZIO URGED THE GOVERNMENT TO MOVE FORWARD ON TAX REFORM. THE BOI GOVERNOR WAS NOT SANGUINE ABOUT GDP GROWTH, PREDICTING

UNCLASSIFIED

PAGE 03 ROME 02694 060232Z

A GROWTH RATE OF 1.5 PERCENT IN 2002. HE DID ACKNOWLEDGE THAT GDP GROWTH COULD EXCEED 1.5 PERCENT, IF INFRASTRUCTURE SPENDING WENT UP IN THE LATTER HALF OF THE YEAR.

3. (U) ON JUNE 3, ECONOMY MINISTER TREMONTI REITERATED THAT THERE WOULD BE NO MID-YEAR CORRECTIVE BUDGET, AND TERSELY ADDED THAT THE GOVERNMENT HAS ALREADY PASSED NEEDED STRUCTURAL REFORMS. TREMONTI DID ACKNOWLEDGE THAT GROWTH PREDICTIONS OF 2.2 PERCENT ARE OPTIMISTIC. HE CONCEDED THAT IN THE MOST PESSIMISTIC SCENARIO, GDP GROWTH IN 2002 WOULD BE JUST 1.3 PERCENT.

4. (SBU) COMMENT: THE BOI GOVERNORS WARNING FLAGS ABOUT THE ITALIAN ECONOMY ARE ONES WE SHARE. THE GOVERNMENT HAS FAILED TO ENACT FUNDAMENTAL ECONOMIC REFORMS AND ITS QUICK POLICY FIXES HAVE FAILED TO PROVIDE A STRONG ECONOMIC STIMULUS (TO BE REPORTED SEPTEL.) ALSO IMPORTANT TO NOTE IS THE HARSHNESS OF THE GOVERNORS CRITICISM. A YEAR AGO, WHEN THE BERLUSCONI GOVERNMENT TOOK OFFICE, THE GOVERNOR WAS OPTIMISTIC ABOUT THE NEW GOVERNMENT AND ITS WILL TO IMPLEMENT ITS AMBITIOUS ECONOMIC PROGRAM. FAZIO'S CRITICISM IS LEGITIMATE IN LIGHT OF ITALY'S ECONOMIC PERFORMANCE. BUT IT ALSO MAY BE A BIT OF POLITICAL MANEUVERING. EARLIER THIS YEAR, MEMBERS OF THE MAJORITY COALITION PROPOSED TO PARLIAMENT A BILL THAT WOULD TURN THE BANK OF ITALY INTO A RESEARCH INSTITUTION AND TRANSFER ITS FUNCTIONS TO INDEPENDENT AUTHORITIES. FAZIO'S STRONG WORDS MAY BE HIS RESPONSE.

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UNCLASSIFIED

PAGE 04 ROME 02694 060232Z

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